Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:JAX:POSTF-153803-01
FLBranch:bjv:BAD

date: November 29, 2001

to: Louise Hawthorne, CTM Team Manager, 1366
Attn: Krista Garlinger, Revenue Agent

from: Area Counsel
(Retailers, Food, Pharmaceuticals & Health Care)

subject: [redacted]
Supplemental Advisory Opinion

On November 5, 2001, our office received input from our National Office regarding our memorandum to you dated October 25, 2001 about the above-referenced taxpayer. A number of issues were raised that we recommend that you take action upon.

Issue 1 and 2: Basis in Foreclosure Property

The Income Tax and Accounting component of our National Office agreed that the [redacted] (hereinafter "[redacted]") would take a basis in the property equal to the bid-in price at the foreclosure. The Corporate component determined that the transaction was a good section 351 transaction which creates a loss that would not be recognized. They also determined that [redacted] (hereinafter "[redacted]") would get a carryover basis - the same as [redacted]' basis.

Issue 3: FIRPTA Liability

In our prior memorandum, we advised that although there was a requirement that [redacted] withhold ten percent (10%) of the amount realized by [redacted] on the section 351 transfer, [redacted] had no tax liability on the exchange and [redacted] would have received a refund of any monies withheld. Therefore, we concluded that withholding 10% of the amount realized would have been mechanical. That latter advice was inaccurate.

Treas. Reg. § 1.1445-1 provides for an absolute duty to withhold a tax equal to 10 percent of the amount realized by the transferor of a United States real property interest (hereinafter "USRPI") if the transferor is a foreign person even if the tax liability is later determined to be zero. Treas. Reg. § 1.1445-

1(e)(3)(ii). A transferee's failure to withhold and to pay over the amounts to the Service subjects the transferee to the tax, penalties and interest. Withholding is not required on a transferred interest that is not a USRPI. Treas. Reg. § 1.1445-2.

A transferee must report and pay over any tax withheld by the 20th day after the date of the transfer. Treas. Reg. § 1.1445-1(c). A person that is required to withhold tax but fails to do so may be held liable for the payment of the tax and any applicable penalties and interest. Treas. Reg. § 1.1445-1(e)(1). Unless the transferor's liability with respect to the transfer is satisfied or is established to be zero, then the tax shall be assessed against and collected from that transferee. Treas. Reg. § 1.1445-1(e)(2)(i). To escape assessment of the tax, the transferor's tax liability must be satisfied by either the transferor's filing of an income tax return and payment of any tax due or by issuance of a withholding certificate by the Service establishing that the transferor's maximum tax liability is zero. Treas. Reg. § 1.1445-1(e)(3)(i). In order for the transferee to avoid liability for the tax, the transferee must provide sufficient information to the Service for the Service to determine whether the transferor's tax liability was satisfied or was established to be zero. Treas. Reg. § 1.1445-1(e)(3)(i).

A transferee who fails to withhold the tax pursuant to section 1445 is also liable for the payment of interest pursuant to section 6601. Interest is payable for the period between the last date on which the tax imposed under section 1445 was required to be paid over to the Service and the date on which the tax is actually paid. Interest is payable on the entire amount that is required to be deducted and withheld. Treas. Reg. § 1.1445-1(e)(2)(ii).

Liability for the payment of interest is not excused by the deemed satisfaction of the liability. In the situation of a deemed satisfaction, interest is payable for the period between the last date on which the tax imposed under section 1445 was required to be paid over and the date (established from information supplied to the Service by the transferee) on which any tax due is paid with respect to the transferor's relevant income tax return or the date the withholding certificate is issued establishing that the transferor's maximum tax liability is zero. Treas. Reg. § 1.1445-1(e)(3)(ii).

As stated in our prior memorandum, an allocation needs to be made between the notes receivable transferred and the real property. The notes receivable are not USRPI and are not subject to the section 1445 withholding. In our analysis of whether any gain or loss was recognized by [redacted] on the transfer, [redacted] received $[redacted] of the note payable in exchange for the USRPI and $[redacted] of the stock in exchange for the USRPI. Therefore, the amount realized on the transfer of the USRPI is $[redacted]. Thus, the amount [redacted] should have withheld and paid over to the Service is $[redacted].

Because [redacted] failed to report and pay over the tax, [redacted] is liable for the full amount of the tax. If [redacted] submits an application for a withholding certificate prior to paying over the tax and the Service determines that [redacted]' maximum tax liability is zero, [redacted] will not be required to pay over the tax. In any event, [redacted] will still be liable for the payment of interest.

If [redacted] chooses to pay over the tax rather than filing an application for a withholding certificate, interest will be charged from the last date on which the tax was required to be paid over to the Service, i.e., twenty (20) days from the date of the transfer through the date on which the tax is paid. If, for example, the date of the transfer was June 10, 1996 and [redacted] paid over the tax on December 31, 2001, interest would be payable from June 30, 1996 through December 31, 2001.

If [redacted] chooses to apply for a withholding certificate and [redacted] tax liability is determined to be zero or if [redacted] files an income tax return and pays the tax, interest will be payable by [redacted] from the last date on which the tax was required to be paid over to either (1) the date the withholding certificate was issued establishing [redacted]' maximum tax liability is zero or (2) the date on which [redacted] paid the tax.

Issue 4: The Taxability of [redacted] on the Transfers of the USRPI

In our prior memorandum we requested more information to determine whether [redacted] was engaged in the trade or business of lending money in order to determine taxability of the exchange of the promissory note and mortgage for the real property at the foreclosure sale. Our National Office has concluded that this determination depends on our classification of [redacted] for the tax year at issue.

The transfer of the promissory note for the mortgages occurred in tax years prior to the "check-the-box" regulations. Therefore, [redacted]' classification must be determined under the Kinter regulations. [redacted] must satisfy at least three (3) of four (4) factors in order to qualify as a corporation. These four factors are: (1) continuity of life, (2) centralization of management, (3) limited liability to corporate property, and (4) free transferability of interests. [redacted]' charter provides for continuity of life, Article 2, centralization of management, Article 5, and limited liability to corporate property, Article 4. The fourth factor is not mentioned and is unknown. However, because [redacted] meets three of the four factors, its classification is that of a corporation.

Our office concludes that we need more information regarding [redacted]' lending activities. (b)(7)a, (b)(5)(AC) [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

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By:
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Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Louise Hawthorne, CTM Team Manager, 1366
Attn: Krista Garlinger, Revenue Agent

from: Area Counsel
(Retailers, Food and Pharmaceuticals)

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subject: [redacted]
Advisory Opinion

This memorandum responds to your memorandum dated January 23, 2001, received in our office on January 29, 2001 wherein you attach documents and request advice on a number of issues.

ISSUES

1. Whether the [redacted], a [redacted] foundation with a United States subsidiary, is entitled to a basis in real property that it obtained through foreclosure of a mortgage it held on the property where the amount the [redacted] bid at the foreclosure sale included unpaid accrued interest as well as actual cash outlays and [redacted] is exempt from [redacted] income tax.

2. Whether [redacted]'s basis in real property is the same as [redacted]'s basis where [redacted] owns [redacted]% of the stock of [redacted] and [redacted] transferred the property to [redacted] in a transaction purportedly falling within I.R.C. § 351.

3. Whether there is FIRPTA tax liability for the transfer of property from [redacted] to [redacted].

4. Whether [redacted] is taxable on any of the transactions. (This potential issue was raised by this office.)

CONCLUSIONS

1. Yes. Generally, the bid-in price at a foreclosure sale becomes the basis of the property in the hands of the successful bidder. (Our answer assumes that the loan transaction was not a disguised sale by [redacted]. (b)(7)a, (b)(5)(AC) [redacted].)

2. If section 351 applies to the transaction, [redacted]'s basis is the same as [redacted]'s basis. If section 351 does not apply to the transaction, [redacted]'s basis in the property and notes receivable is equal to $[redacted] -- the consideration in the form of stock and notes payable that [redacted] paid to [redacted].

3. Yes. However, [redacted] realized no gain in the transaction and would have been entitled to a refund of the amount withheld.

4. Additional facts are necessary for our office to make this determination.

DISCUSSION

[redacted] (hereinafter "[redacted]") is a [redacted] foundation. The entity has the characteristics of both a trust and a corporation. [redacted] law exempts [redacted] from submitting any financial statements on an annual basis to the [redacted] government. [redacted] is considered a holding company that limits its activities to the administration or management of assets or investments. Additionally, [redacted] is exempt from [redacted] income tax. The United States and [redacted] have no income tax treaty.

[redacted] is the owner of the stock of [redacted] (hereinafter "[redacted]"), a United States real property holding corporation. [redacted] engaged in three (3) lending transactions with unrelated borrowers in the United States that are of interest in the audit of [redacted]. A description of a fourth lending transaction was also submitted for background information.

<u>The [redacted] Transaction</u>

[redacted] loaned $[redacted] to the [redacted], an unrelated party, at a [redacted]% interest rate in [redacted]. The [redacted] secured the loan by giving a mortgage on vacant land in [redacted], [redacted] (hereinafter "the [redacted] property") that it owned.

Interest payments only were due every four months with the principal balance due in three years, [redacted]. The [redacted] defaulted on its interest payments to [redacted]. [redacted] began foreclosure proceedings in [redacted]. [redacted] was granted summary judgment in [redacted] and [redacted]. The successful bid-in price included the final judgment amount plus unpaid accrued interest to the date of'the foreclosure sale. [redacted] transferred the property to [redacted] in a section 351 transaction sometime during [redacted]'s taxable year ending [redacted]. [redacted] computed its basis in the [redacted] property to include the foreclosure bid-in price plus other costs associated with the sale for a total basis of $[redacted].

The [redacted] Transaction

[redacted] loaned $[redacted] to [redacted], an unrelated party, at an [redacted]% interest rate in [redacted]. The funds were to be used to purchase vacant land in [redacted]. The note was a short-term balloon note, due in [redacted]. Both principal and interest was due at that time. This note was secured by property located in [redacted], [redacted], owned by [redacted]. The note was also secured with property owned by [redacted] and [redacted]., a [redacted] corporation. Both of these properties were located in [redacted], [redacted]. [redacted] defaulted on payment of the note and [redacted] began foreclosure proceedings sometime in [redacted]. A final summary judgment was entered in [redacted]' favor on the property located in [redacted] in [redacted]. The amount of the judgment included unpaid interest from the beginning of the loan. The bid price at the foreclosure sale included the final judgment plus unpaid accrued interest and costs. Sometime during [redacted]'s tax year ending [redacted], [redacted] transferred the property to [redacted] in a section 351 transaction. [redacted]s computation of basis in the properties included the bid-in price, for a total basis of $[redacted].

The summary judgment also granted a judgment against the guarantors of the notes. The rights to collect this judgment was also transferred to [redacted] as a note receivable. [redacted] recorded this note receivable with a basis of $[redacted].

The [redacted] Transaction

[redacted] loaned funds to [redacted] (hereinafter [redacted]), an unrelated corporation, which [redacted] subsequently loaned to [redacted] (hereinafter "[redacted]"), a corporation related to [redacted]. The first loan, which was for [redacted], occurred in [redacted]. The second loan, which was for [redacted], occurred in [redacted]. These loans were secured by mortgages on real property located in [redacted] which [redacted] assigned to [redacted] and were recorded by [redacted] in [redacted]. [redacted] began foreclosure procedures against [redacted] in [redacted]. A partial summary judgment was entered in [redacted]' favor in [redacted] in [redacted]. [redacted] filed for Chapter 11 bankruptcy in [redacted]. During the bankruptcy proceeding, the state court action was removed to the bankruptcy court. The trustee and [redacted] settled the controversy whereby the trustee sold the property to [redacted]. [redacted] mortgages were allowed as a secured claim in the amount of the [redacted] state court judgment amount. [redacted] bid this amount plus other costs at the bankruptcy sale. [redacted] transferred the property to [redacted] sometime during [redacted]'s tax year ending [redacted], in a section 351 transaction. [redacted] recorded this property with a basis of $[redacted].

The summary judgment also granted a judgment against the guarantors of the notes. The rights to collect this judgment was also transferred to [redacted] as a note receivable. [redacted] recorded this note receivable with a basis of $[redacted].

According to additional information received in our office March 12 and 14, 2001, in exchange for the real properties, [redacted] received additional stock and a note. The additional stock increased [redacted]'s paid-in capital account by $[redacted] and the note increased [redacted]'s notes payable account by $[redacted].

Issue 1

A transfer of mortgaged property through a foreclosure proceeding in discharge of a mortgage debt is treated as a sale or exchange of the mortgaged property. Generally, the successful bid amount at a foreclosure sale is deemed to be the fair market value (hereinafter "FMV") of the property and becomes the successful bidder's basis in that property. The Service must dispute this amount with clear and convincing proof to the contrary. See Treas. Reg. § 1.166-6. Thus, [redacted]' successful bid is [redacted]' basis in the property in each of the above transactions.

Issue 2

The basis of property that is acquired by a corporation in a transaction to which section 351 applies is the same as it was in the hands of the transferor, increased in the amount of gain recognized by the transferor on the transfer. I.R.C. § 362(a). Thus, if section 351 applies to the transaction, the basis in the property includes the bid-in price plus the amount of gain, if any, recognized by [redacted] on the transfer. See infra. If section 351 does not apply to the transaction, [redacted]'s basis in the property and notes receivable is equal to $[redacted] -- the consideration in the form of stock and notes payable that [redacted] paid to [redacted].

Issue 3

When a foreign corporation disposes of a United States real property interest (hereinafter "USRPI"), gain shall be taken into account under section 882(a)(1) as if the foreign corporation were engaged in a trade or business within the United States and as if the gain were effectively connected with such trade or business. I.R.C. § 897(c). Section 897(e) provides that any nonrecognition provision shall apply to a transaction in specific instances. I.R.C. § 897(e). Section 351 is included. Treas. Reg. § 1.897-6T(a)(2). Treasury Regulation § 1.897-6T provides that a non-recognition provision shall apply only to the extent that the transferred USRPI is exchanged for a USRPI which would be subject to U.S. taxation upon its disposition and the transferor complies with the filing requirements of Treas. Reg. § 1.897-5T(d)(1)(iii). Stock in a real property holding company is a USRPI. I.R.C. § 897(c)(1)(A)(ii). The filing requirement is that the foreign corporation file an income tax return in the year of the transfer of the USRPI. Treas. Reg. § 1.897-5T(d)(1)(iii). No information was submitted regarding whether [redacted] met the filing requirements under this regulation.

Assuming that [redacted] failed to file an income tax return in the year of the transfer, the transaction would not qualify for nonrecognition treatment under section 351. The regular gain and loss rules would apply under section 1001 and the regular basis rules would apply. Pursuant to the regular rules, [redacted] would realize a loss of $[redacted]. The amount realized of $[redacted] ($[redacted] stock + $[redacted] note payable) is less than the adjusted basis in the properties and note receivables transferred of $[redacted]. I.R.C. § 1001. The loss attributable to the USRPI transferred would then need to be calculated to determine the loss to be recognized by [redacted] [redacted]'s total basis in the USRPI and note receivable would equal the amount [redacted] paid for the property and note which was $[redacted]. I.R.C. § 1012. This basis amount would need to be apportioned among the properties according to each property's FMV.

If we assume that [redacted] filed or will file an income tax return, the regulations under section 897 would apply to the transaction. Under these rules, [redacted] would recognize no gain or loss; [redacted] would have a basis in the property and notes receivable determined under section 362; and [redacted]' basis in the stock and note payable issued by [redacted] would be determined under section 358.

Under Treas. Reg. § 1.897-6T(a)(8)(ii), the transfer of the USRPI and note receivable in exchange for the stock and note payable issued by [redacted] would be considered a mixed exchange. A mixed exchange occurs where both a USRPI and other property (notes receivable) is exchanged for both property the receipt of which would qualify for nonrecognition treatment (stock) and for other property (note payable). Treas. Reg. § 1.897-6T(a)(8)(ii). In this particular situation, special gain rules under Treas. Reg. § 1.897-6T(a)(8)(ii) apply.

The amount of non-qualifying property (note payable) considered to be received in exchange for the USRPI must be determined by multiplying the FMV of the nonqualifying property (note payable) by a fraction, the real property fraction. The numerator of the real property fraction is the FMV of the USRPI transferred. The FMV of the USRPI was determined supra at Issue 1 to be the bid-in price at the foreclosure sale. The numerator of the fraction would be $[redacted].[1] The denominator of the fraction is the FMV of all property transferred, $[redacted]. [redacted] is considered as having received $[redacted] of the $[redacted] note payable in exchange for the USRPI.[2] Treas. Reg. § 1.897-6T(a)(8)(ii)(A).

[redacted] would recognize gain in the amount of the lesser of the previously determined amount, $[redacted], and the realized gain with respect to the USRPI. Treas. Reg. § 1.897-6T(a)(8)(ii)(B). The realized gain with respect to the USRPI is $[redacted] which is the lesser amount; thus, no gain would be recognized by [redacted] under sections 351 and 897.

[redacted] is considered to have received $[redacted] of the note payable in exchange for the notes receivable it transferred to [redacted] ($[redacted] [total value of note payable received] minus $[redacted] [portion of note payable received in exchange for the USRPI]). Treas. Reg. § 1.897-6T(a)(8)(ii)(C)(*1*). [redacted] is considered to have received $[redacted] of the stock in exchange for the USRPI ($[redacted] [total stock value received] multiplied by the real property fraction) and $[redacted] of the stock in exchange for the notes receivable. Under section 351, no loss would be recognized.

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[1] We derived this number from the total of all three properties' basis showing on [redacted]'s books. A number of assumptions were made. We assumed that all the properties were transferred during the same transaction. Obviously, if this is not the case, our analysis would be different. We also assumed that [redacted] did not add or subtract any other costs to [redacted]' bid-in price and that the amount shown as basis on [redacted]s books is equal to [redacted] bid-in price at the foreclosure sales.

[2] ($[redacted]) multiplied by $[redacted].

Unless an exception applies, in the case of any disposition of a United States real property interest (hereinafter "USRPI"), the transferee is required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition. I.R.C. § 1445(a). The amount realized by a foreign corporation for purposes of section 897 and the withholding requirements is the sum of cash paid plus the FMV of other property transferred plus the outstanding amount of any liability assumed by the transferee or to which the USRPI is subject. Treas. Reg. § 1.1445-1(g)(5). No exceptions apply in this instance.

Because [redacted] received a note payable issued by [redacted] in the amount of $[redacted] along with the stock in the exchange, it appears that [redacted] should have withheld $[redacted] pursuant to section 1445. However, because [redacted] also transferred notes receivable to [redacted] along with the real property, an allocation would need to be made. The amount of the stock and notes payable issued by [redacted] to [redacted] that is attributable to the notes receivable are not subject to I.R.C. §§ 897(c) and 1445 because the notes receivable are not USRPIs. For example, if $[redacted] of the note payable was attributable to the notes receivable transferred by [redacted] in the exchange, [redacted] would be required to withhold $[redacted] (10% of ($[redacted]-$[redacted]) due to the disposition of the USRPI (real property).

Issue 4

At the foreclosure sale, [redacted] exchanged a promissory note and mortgage for the real property with a FMV equal to their bid-in price. In each instance, the basis in the promissory note and mortgage was less than the amount realized on the exchange resulting in gain. Whether or not that gain is taxable depends on whether [redacted] is considered to be engaged in a trade or business within the United States within the meaning of section 864 and 882. Our office believes that more information is necessary before we can make a determination as to whether [redacted] was engaged in the trade or business of lending money.

Treasury Regulation § 1.864-4(c)(5) provides that a foreign corporation is considered to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year, the taxpayer is (1) engaged in business in the United States and (2) the activities of the business consists of one or more of six (6) activities. These activities are as follows:

(a) Receiving deposits of funds from the public,

(b) Making personal, mortgage, industrial, or other loans to the public,

(c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(d) Issuing letters of credit to the public and negotiating drafts drawn thereunder

(e) Providing trust services for the public, or

(f) Financing foreign exchange transactions for the public.

Under the facts given to our office, [redacted] engaged in at least one of the activities -- "making personal, mortgage, industrial, or other loans to the public" by making loans to unrelated parties. Although, [redacted] engaged in at least one of those activities, the regulation also requires [redacted] to be "engaged in business within the United States" at some time during the taxable year. Making loans to different parties can also be construed as merely investing activities, not business activities.

Case law in the domestic area is instructive in determining whether a taxpayer's activities in making loans have been regarded as so extensive and continuous as to elevate the activity to the status of a separate business. Some of the factors to consider in determining whether an individual or corporation is engaged in the trade or business of lending money include: the number of loans made by the taxpayer, the time period over which such loans were made, the adequacy and nature of the taxpayer's records, the amount of time devoted to the lending activity, whether the taxpayer actively sought out the lending business, whether the taxpayer advertised or maintained a separate office for the business, the maintenance of separate books and accounts for the business or profit and loss statements, the taxpayer's general reputation in the community as a lender and the relationship of the debtors to the taxpayer/ lender. <u>Ruppel v. Commissioner</u>, T.C. Memo. 1987-248. All the factors need not be present, nor is any factor weighed more heavily than others. The determination is strictly factual in nature.

(b)(7)a, (b)(5)(AC)

[redacted]

, (b)(7)a, (b)(5)(AC)

[redacted]

Final Conclusion

Although [redacted] should have withheld the required amounts, the practical result is that even if [redacted] had withheld any amount, if [redacted] had filed a claim for refund, all monies withheld would have been refunded because [redacted] realized no gain on the transactions. The note payable issued by [redacted] to [redacted] should be examined to determine what, if any, interest is payable to [redacted]. If interest is payable to [redacted], [redacted] is required to withhold 30 percent of the payment as tax pursuant to I.R.C. § 1442. Because [redacted] owns [redacted]% of [redacted] the interest is not portfolio interest. See I.R.C. §§ 881(c)(3)(B); 871(h)(3)(B). Additionally, more information is needed to determine whether [redacted] is engaged in the trade or business of lending money.

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By:______________________________
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